SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 894

EDWARD H. WEITZEN et al.,

Petitioners,

—against—

CHARLES HEIT et al.,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI

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RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI

Opinions Below

The opinion of the Court of Appeals is reported, *Heit* v. *Weitzen*, 402 F. 2d 909 (2 Cir. 1968). The opinions of the District Court are reported, *Heit* v. *Weitzen*, 260 F. Supp. 598 (SDNY 1966), and *Howard* v. *Levine*, 262 F. Supp. 643 (SDNY 1965).

Statement of the Case

Since this consolidated case comes to the Court on a challenge to the legal sufficiency of the complaints (Pet. 5b, 1c), the allegations of the complaints must be taken as true and form the factual framework of the controversy. The petition strays far from the pleadings and the record. Actually the material facts are simple.

Petitioners, defendants below, are the Belock Instrument Corporation (Belock), its directors, officers, auditors and controlling stockholder (16a, 68a-70a).* Belock's stock and debentures are listed on the American Stock Exchange and are traded over the counter (16a, 70a). Petitioners materially falsified Belock's financial statements by adding fictitious profits from its Government contracts to its assets and earnings (17a, 71a-72a). Petitioners filed the false reports with the SEC and distributed them to the public (17a, 71a). They knew the statements to be false (18a, 72a).** They knew and intended that the false statements would artificially inflate the market price of Belock's securities (18a, 72a). They knew and intended, therefore, that numerous investors would be misled into buying the securities at the excessive prices. In reliance on petitioners' misstatements and on the integrity of the market price, respondents (plaintiffs below) and many other investors did buy the stock and debentures at the inflated prices, to their damage (18a, 73a).

Upon these allegations, respondents seek damages for themselves and other investors similarly deceived. The claim is based on §§ 10(b) and 18(a) of the Securities Exchange Act, 15 USC §§ 78j(b) and 78r(a), and SEC Rule 10b-5, 17 CFR § 240.10b-5.***

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* The Appendix to respondents' brief below is cited as "—a".

** As held by the Court of Appeals (Pet. 8a-9a), the alternative allegation that defendants should have known the falsity of their representations may, under FRCP 8(e)(2), be ignored.

*** The text of § 10(b) and of Rule 10b-5 is set forth in the petition (p. 4). The petition raises no question concerning the claim under § 18(a).

The Question Presented

Section 10(b) and Rule 10b-5 make it unlawful to commit fraud "in connection with the purchase or sale of any security." Petitioners do not here dispute that their fraud was intended to and did induce numerous investors, including respondents, to purchase Belock's securities at inflated prices. Nevertheless, they contend that their fraud was not "in connection with the purchase or sale of any security" because they themselves did not buy or sell securities. This is the sole question the petition (p. 3) presents to the Court.

The arguments of the petition, however, range far beyond this single narrow issue. Petitioners also disclaim liability because Belock's losses, concealed from the public, resulted from its misconduct in dealing with the Government (Pet. 12-13, 18-19); and because petitioners' "purpose", "motive" or "desire" was to conceal their misconduct from the Government rather than to inflate the market price (Pet. 13). Out of precaution, we shall briefly discuss these arguments along with the question actually presented to the Court.

REASONS FOR DENYING THE WRIT

I

The question raised by the petition is insubstantial and has recently been answered by this Court.

1. Rule 10b-5 does not require "privity".

The question posed by the petition (p. 3) needs clarification. Petitioners do not contend that a 10b-5 claim depends on "privity" between the perpetrator and the victim of the fraud. In other words, a defrauded purchaser of securities need not have bought them from the wrongdoer in order to invoke the rule against him.

Petitioners are well advised not to rely on privity. Even the common law of fraud has long abandoned that requirement, *Fischer* v. *Kletz*, 266 F. Supp. 180, 187 (SDNY 1967), and the authorities under § 10(b) and Rule 10b-5 are virtually unanimous in rejecting it.*

Admittedly, therefore, it is no defense to the 10b-5 claims here alleged that respondents bought their Belock securities in the market rather than from petitioners.

2. Rule 10b-5 does not require a securities transaction by the wrongdoer.

With their foregoing concession, petitioners are driven to a novel interpretation of § 10(b) and Rule 10b-5. They

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* *Texas Continental L. Ins. Co.* v. *Dunne*, 307 F. 2d 242, 249 (6 Cir. 1962); *Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F. 2d 540, 543-4 (2 Cir. 1967); *Fischer* v. *Kletz*, 266 F. Supp. 180, 192-3 (SDNY 1967); *Brennan* v. *Midwestern United L. Ins. Co.*, 259 F. Supp. 673, 682-3 (N.D. Ind. 1966); *Bredehoeft* v. *Cornell*, 260 F. Supp. 557, 559 (D. Ore 1966); *Miller* v. *Bargain City*, 229 F. Supp. 33, 37 (E.D. Pa. 1964); *Freed* v. *Szabo Food Service*, 1961-64 CCH Fed. Sec. L. Rep. ¶ 91,317, at pp. 94,363-4 to 94,363-5 (N.D. Ill. 1964); *New Park Mining Co.* v. *Cranmer*, 225 F. Supp. 261, 266 (SDNY 1963). *But see Donovan, Inc.* v. *Taylor*, 136 F. Supp. 552, 553 (N.D. Cal. 1955).

say that defrauded purchasers of securities can sue only if the wrongdoer had securities dealings with *someone,* even though only with a third party. This theory, if accepted, would give petitioners the privilege to deceive the investing public with impunity provided only that they themselves did not buy or sell securities from or to someone.*

Petitioners do not explain why the wrongdoer's dealings with a third and wholly unrelated party should be relevant to his liability to his victim. The contention lacks any rational basis and defies common sense.

Nor does it find any basis in the language or purpose of the statute or rule. There is nothing magic or mysterious to the phrase "in connection with the purchase or sale of any security." Had these words been omitted from § 10(b), the statute would have applied to the fraud-induced purchase or sale of a horse or of land. Congress, however, intended to protect only defrauded purchasers or sellers of *securities.* The "in connection" clause was designed to express this limitation.

The requisite "connection" between the fraud and a securities transaction thus is the traditional causal connection. It exists if the fraud induces the defrauded person to buy or sell securities. This is the only "connection" the statute requires. According to petitioners, there must be a second connection; in addition to the fraud-induced securities transaction of the victim, they say, there must also be a fraud-connected securities transaction by the wrong-

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* For instance, a corporation procuring a loan from a bank or factor by means of a false financial statement might well include that statement in its published annual report in order not to "tip off" the lender. On petitioners' theory, the investors induced by the false statement to buy the corporation's securities would be without remedy because the corporation itself had no securities transaction.

doer. The statute, however, prescribes only one connection, not two.

Petitioners' interpretation flies in the face of the manifest purpose of § 10(b) and Rule 10b-5. The Exchange Act is a remedial statute designed for the protection of investors; *Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967). Indeed, § 10(b) itself expressly recites "the protection of investors" as its objective. The protection is to be insured by "the maintenance of fair and honest markets" in securities; § 2, 15 USC § 78b. As stated by the House Committee reporting on the 1934 legislation, "There cannot be honest markets without honest publicity * * *."*

Petitioners' false statements caused the artificial inflation of the market price of Belock's securities. Dishonest publicity thus created a dishonest market. This was the very evil from which investors such as respondents were to be protected.

Petitioners would carve an exception from the broad protection afforded investors by the Act. They claim that they had a license to deceive the market and to defraud investors because they did not buy or sell any securities. The Act permits no such distinction. To import a defense like this into the statute and rule would put a premium on dishonesty, contrary to the "philosophy of full disclosure" and the "high standard of public ethics in the securities industry" mandated by Congress; *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963). An investor buying securities on a national exchange ordinarily does not know the identity of his seller; his need for protection from fraud is no different whether or not the perpetrator

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* H.R. Rep. No. 1383, 73rd Cong., 2d Sess. (1934), p. 11. See also S. Rep. No. 1455, 73rd Cong., 2d Sess. (1934), p. 68.

happens to be a seller of securities. Giving controlling weight to adventitious circumstances such as these would permit—in the words of *SEC* v. *Howey Co.*, 328 U.S. 293, 301 (1946)—"the statutory policy of affording broad protection to investors * * * to be thwarted by unrealistic and irrelevant formulae."

3. A recent decision of this Court in effect rejects petitioners' position.

Petitioners fail to cite a single authority for their theory; nor do we find any in Judge Moore's dissent in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833, 870 (2 Cir. 1968), on which petitioners stake their case.*

In *SEC* v. *National Securities, Inc.*, —— U.S. ——, 37 U.S. Law Week 4101 (Jan. 27, 1969), this Court dealt with the merger of two insurance companies, Producers Life and National Life. The SEC attacked the merger on the ground that the proxy statement issued to the stockholders of Producers withheld material information, in violation of § 10(b) and Rule 10b-5. The defendants contended that the alleged fraud was not "in connection with the purchase or sale of any security" (p. 4104); but this Court had no difficulty finding the connection (p. 4105):

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* Judge Moore concluded his discussion of earlier authorities with the statement that "[i]n all of the above cases the defendants * * * were clearly participants in a securities transaction * * *" (401 F. 2d at 888). Even if this were true it would not prove that such participation was a necessary element of the 10b-5 fraud, unless the courts so treated it. None of them did. We submit, however, that Judge Moore misread some of his authorities. The defendant broker in *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215 (SDNY 1965), did not buy or sell any securities. Neither did any of the defendants in *Miller* v. *Bargain City*, 229 F. Supp. 33 (E.D.Pa. 1964). Neither did the defendant broker in *Glickman* v. *Schweickart & Co.*, 242 F. Supp. 670 (SDNY 1965), or the defendant finance company in *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (SDNY 1964), or the defendant accountants in *Fisher* v. *Kletz*, 266 F. Supp. 180 (SDNY 1967).

> "The deception furthered a scheme which resulted in their [the stockholders of Producers] losing their status as shareholders in Producers Life and becoming shareholders in a new company. Moreover, by voting in favor of the merger, each approving shareholder individually lost any right under Arizona law to obtain an appraisal of his stock and payment for it in cash. * * * here an alleged deception has affected individual shareholders' decisions in ways not at all unlike that involved in a typical cash sale or share exchange. The broad anti-fraud purposes of the statute and the rule would clearly be furthered by their application to this type of situation."

The "connection" of the fraud with a securities transaction thus rested on the fact that the fraud induced the deceived investors to sell their shares. This Court did not so much as hint that additionally a sale or purchase of securities by the perpetrators of the fraud was necessary. The type of connection found sufficient in *National Securities* is, of course, equally present here.

National Securities, to be sure, involved a suit by the SEC rather than a private damage action; but this affords no distinction.* The requisite "connection" of the fraud with a purchase or sale of securities is the same in both types of litigation; the fortuitous presence or absence of securities dealings by the wrongdoer is as irrelevant when investors sue for themselves as when their interests are represented by the SEC.**

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* Judge Moore's dissenting views in *Texas Gulf Sulphur* (401 F. 2d 833) related to an action by the SEC.

** None of the complex questions of "standing" to sue to which this Court adverted (note 9), arises in the present case. As indicated by the *Lowenfels* article cited by this Court (ibid.), a private investor's 10b-5 standing may or may not depend on his actually having bought or sold a security in reliance on the misrepresentations. Such purchases are here clearly alleged, so that respondents' "standing" is unquestioned.

In the light of *National Securities,* of the clear purpose of the statute and rule, and of plain common sense, we submit that the question posed by petitioners is too insubstantial to warrant review by this Court.

II

Petitioners are not relieved from 10b-5 liability because they also committed a fraud upon the Government.

In searching for exculpatory arguments, petitioners have devised a theory of remarkable boldness. Belock, it is alleged in the complaints, had large contracts with the Government; by cheating the Government, it derived fictitious profits from the contracts; and it included these non-existing profits among the assets and earnings it reported to the public. According to petitioners, the public has no ground to complain of Belock's false financial reports because the falsity arose from "corporate misconduct" (Pet. 12-13, 18-19).

Petitioners' own illustration will serve to answer them. According to the petition (p. 12):

> "If, for example, a corporate officer, *unbeknownst to anyone,* embezzles large sums from the corporate till, any balance sheet issued by the corporation prior to the discovery of the embezzlement will contain a false statement of the corporation's assets." (Emphasis added)

The key words here are "unbeknownst to anyone". The complaints allege knowledge on the part of all petitioners. It does not need argument that a known corporate loss, whether or not due to "corporate misconduct", cannot be intentionally withheld from the financial statements without consequent fraud liability under 10b-5. If an officer has stolen a million dollars from his corporation, the money

is no longer in the till, and it is fraud to misrepresent knowingly that it is still there.

It may, indeed, be unpleasant for those guilty of "corporate misconduct" to reveal their misdeeds to the public. So far, however, the duty of truth in corporate reporting has not been displaced by concern for corporate malefactors.

Petitioners complain *ad misericordiam* that corporate liability to investors defrauded by false reports may give rise to very large claims. Perhaps so; but Congress designed the Exchange Act to protect the investors, not the originators of false reports. Of course, liability presupposes culpability; whether that is actual knowledge or some degree of negligence need not here be resolved.

The "electrical equipment cases" are not the horrible examples made out by petitioners (Pet. 18-19). Complex antitrust cases often lie in a penumbra between legality and illegality, so that an officer's honest belief in the innocence of his conduct may excuse the lack of public revelation. No such excuse will avail petitioners, who simply charged the Government with fictitious expenses.

It is "of course, the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley* v. *Gibson*, 355 U.S. 41, 45-46 (1957). It would be competent for respondents to prove a representation made by petitioners that Belock owed the Government no refunds under its contracts,* when petitioners actually knew that

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* The SEC's amicus brief below (Note 43) referred to Belock's 1964 annual report issued in 1965, which recited:

> "Renegotiation proceedings for the fiscal years through October 31, 1963 have been completed. No provision for refunds for 1964 has been made or is believed necessary."

the Government had been fraudulently overcharged.* The question whether such proof or other evidence is available cannot be determined at this stage of the controversy, but must be left for the trial of the action.

III

Liability under Rule 10b-5 does not depend on a fraudulent purpose or motive on the part of the wrongdoer.

Petitioners (p. 13) suggest that they are not liable for their misstatements because they did not act "with the intention, desire, or for the purpose, of inducing purchases or sales of the corporate securities". Presumably, they claim that they "desired" only to withhold the fraud from the Government.

We submit that petitioners' "purpose" or "desire" is immaterial. The common law requires an "intention" to deceive (as distinguished from a purpose or motive); the intention, however, will be implied from a false representation knowingly made, "for the law presumes every man to intend the natural consequences of his acts". *Claflin* v. *Commonwealth Ins. Co.*, 110 U.S. 81, 95 (1884); *Agnew* v. *United States*, 165 U.S. 36, 53 (1897); *Restatement, Torts 2d*, § 8A (1965). Once this kind of intent is present, the "purpose" or "desire" of the perpetrator of the fraud is irrelevant; *Restatement, Torts* (1938), § 531, Comment (a):

> "Thus a person who believes that another is substantially certain to act in a particular way as a result of a misrepresentation intends such result although he did not act for the purpose of causing it or even if he did not desire it."

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* Belock's principal officers have been convicted of such fraud against the Government or have pleaded guilty (Pet. 5-6).

The present complaints allege petitioners' "intent" to cause an artificial inflation of the market price (18a, 72a), i.e., their intent to cause purchases and sales at the inflated prices. Under the common law authorities, no further purpose or desire is necessary.

Since § 10(b) and Rule 10b-5 are designed to strengthen the protection of investors, their requirements cannot be stricter than those of the common law. Indeed, the lower courts are in virtual agreement that "[i]n an action brought under section 10(b), common law fraud need not be alleged or ultimately proved."* It would thus be the height of incongruity to read into Rule 10b-5 a requirement of fraudulent "purpose", which even the common law rejects.

CONCLUSION

The writ of certiorari should be denied.

Dated: February 7, 1969.

Respectfully submitted,

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